Improvements Are Needed in Establishing Yearly Offset Fees for the Treasury Offset Program

November 2001

Reference Number: 2002-10-006

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

November 15, 2001

MEMORANDUM FOR COMMISSIONER, INTERNAL REVENUE SERVICE
COMMISSIONER, FINANCIAL MANAGEMENT SERVICE

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Improvements Are Needed in Establishing Yearly Offset Fees for the Treasury Offset Program (Audit # 200110006)

This reports presents the results of our review of the establishment of yearly offset fees for the Treasury Offset Program (TOP). The objective of the review was to determine the accuracy of offset fees associated with two segments of the TOP: the Tax Refund Offset (TRO) service and the Tax Levy (TL) service.

In summary, a reasonable fee was established for the Internal Revenue Service's (IRS) share of the TRO services. While the Financial Management Service's (FMS) total program budget was reasonable, fees established for TRO services did not reflect estimated FMS costs or allow for full recovery of costs incurred for the services. Further, the fee established for the TL service was not sufficiently supported, nor was the IRS/FMS Interagency Agreement updated to reflect current levy conditions.

IRS management concurred with our recommendation and requested a change in the Fiscal Year (FY) 2001 Interagency Agreement on August 9, 2001, and estimated the funding needed for the FY 2002 agreement based on more accurate historical data.

FMS management also concurred with our recommendations. The FMS captures costs associated with the debt program in an activity-based cost model. In order to move the debt collection program towards full reimbursement, fees are increased each year, and shortfalls are covered by direct appropriation. Fee increases are held as low as possible to avoid unduly burdening agencies. The FMS will document the process used to isolate and track the additional costs associated with the TL service. As the levy program continues, the IRS and the FMS should be able to gain experience with estimating the number of levies and associated costs with more precision.

In its response, the FMS commented that the Treasury Inspector General for Tax Administration's (TIGTA) statement concerning offset fees being substantially less than required to ensure reimbursement of total program costs, which resulted in a projected program shortfall, was incorrect. The FMS stated that the program is not a fully reimbursable program, and it receives some direct appropriated money to support the program. The FMS expressed concern that the statement implied that FMS management made an arbitrary adjustment that caused a shortfall.

The TIGTA continues to believe that the Code of Federal Regulations requires agencies to reimburse the FMS for the full cost of the offset program, which would negate the need for direct appropriations to support the program. The TIGTA is encouraged that the FMS is working towards full reimbursement, and again suggests that decisions to not cover total costs be documented to fully support how fees are established.

The FMS and IRS management's comments have been incorporated into the report where appropriate, and their complete responses are included as Appendices V and VI, respectively.

Copies of this report are also being sent to the IRS and FMS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

Table of Contents

Executive Summary

The Financial Management Service (FMS) is a bureau of the Department of the Treasury, and part of its mission is to provide centralized debt collection services to most federal agencies. The Debt Management Services of the FMS is responsible for the Treasury Offset Program (TOP). The TOP is a mandatory, governmentwide debt collection program that compares delinquent debtor data to federal payment data. The TOP recovers delinquent debt by offsetting federal payments scheduled to be issued to debtors.

The Internal Revenue Service (IRS) and the FMS work together to administer two of the TOP debt collection services, the Tax Refund Offset (TRO) and the Tax Levy (TL). These two services are funded by establishing a fee for each offset processed. The overall objective of this review was to determine the accuracy of offset fees associated with these two services.

Results

The IRS and the FMS have processes in place to identify total costs associated with the TRO and the TL services. A reasonable fee was established for the IRS' share of TRO services. While the FMS' total TOP budget was reasonable, fees established for the FMS' share of the TRO services did not directly reflect estimated FMS costs or allow for full recovery of costs incurred for the services. Further, the fee established for the TL service was not sufficiently supported, nor was the IRS/FMS Interagency Agreement updated to reflect current levy conditions.

The Internal Revenue Service Fee Structure for the Tax Refund Offset Services Substantially Covered Its Estimated Program Costs

For Calendar Year (CY) 2001, the IRS established its TRO per-offset fee at $4.70. The IRS derived this fee by estimating its total costs ($13,067,730) for participation in the TRO service and then dividing that amount by the number of estimated offsets (2,781,771). Based on available supporting documentation, the IRS' CY 2001 TRO offset fee is reasonable in covering its estimated costs. Our opinion is based on the IRS' accurate application of offset assumptions to detailed schedules of IRS direct, indirect, and administrative cost data, the result of which was then used to establish the IRS' TRO offset fee.

While the Financial Management Service's Total Offset Program Budget Was Reasonable, Tax Refund Offset Fees Did Not Directly Reflect Estimated Costs or Allow for Full Recovery of Costs Incurred

For Fiscal Year (FY) 2001, the FMS estimated the total costs of the TOP, of which the TRO is a service, to be $32,405,767 and the total TOP anticipated offsets to be 2,823,606. We were able to trace the total estimated cost figures and anticipated TRO offsets to supporting documentation and, in our opinion, these figures are reasonable.

However, the FMS established TOP individual service offset fees, based on the type of offset, that were not directly reflective of estimated FMS TOP costs. These offset fees, though higher than in previous years, were still substantially less than required to ensure reimbursement of total FY 2001 program costs, as we believe is required by the Code of Federal Regulations,[1] and resulted in a projected program shortfall of $13,877,087. The FMS explained that it receives special appropriated funds and makes use of other direct FMS appropriations to cover any shortfalls that result from the establishment of offset fees charged to creditor agencies that do not cover incurred costs.

Based on the above, we are unable to comment on the reasonableness of the individual TRO offset fees established by the FMS for FY 2001, other than to state that the offset fees established, combined with the FMS appropriations, covered the estimated cost of the TRO service.

The Tax Levy Service Fee Was Not Sufficiently Supported, Nor Was the Interagency Agreement Updated to Reflect Current Levy Conditions

Both the FMS and the IRS were aware that the TL service is more costly than other offset services. As a result, the FMS established a per-offset fee of $12.60 for the TL service for FY 2001. However, the FMS did not accumulate administrative costs by individual debt collection service, including the extra cost of the IRS' request for additional actions associated with the TL service. Therefore, no detailed cost documentation was available to support the establishment of the TL offset fee. Without identifying the additional costs associated with the TL service, the FMS cannot be certain that the $12.60 fee charged to the IRS is appropriate or sufficient.

The FY 2001 IRS/FMS Interagency Agreement for the TL service was signed on January 31, 2001, and provided for reimbursement from the IRS to the FMS of $1,599,998 for 126,984 levies (at $12.60 each).

[1] 31 CFR §§ 285.2(i), 285.3(h), and 285.8, as of September 7, 2000.

The FMS reported the recording of 24,061 levy actions as of May 23, 2001. Using this amount, and giving consideration to an increase in levy actions from late February through May, we estimate the completion of approximately 43,200 levies through the end of FY 2001 at a projected cost of $544,320. Though the actual reimbursement to the FMS will ultimately be based on the number of actual levy actions, the current IRS commitment amount of $1,599,998 represents a possible $1.1 million overcommitment of IRS appropriated funds that are unavailable for other IRS expenditures.

Summary of Recommendations

The FMS should ensure that TRO offset fees reflect the total costs of the corresponding debt collection services and that actual costs of TL offsets are recorded. Further, the IRS and FMS should ensure that Interagency Agreements are updated to reflect the most current offset conditions and cost information.

Management's Responses: IRS management concurred with our recommendation and requested a change in the FY 2001 Interagency Agreement on August 9, 2001, and estimated the funding needed for the FY 2002 agreement based on more accurate historical data.

FMS management concurred with our recommendations. The FMS captures costs associated with the debt program in an activity-based cost model. In order to move the debt collection program towards full reimbursement, fees are increased each year, and shortfalls are covered by direct appropriation. Fee increases are held as low as possible to avoid unduly burdening agencies. The FMS will document the process used to isolate and track the additional costs associated with the TL service. As the levy program continues, the IRS and the FMS should be able to gain experience with estimating the number of levies and associated costs with more precision.

Office of Audit Comment: In its response, the FMS commented that the Treasury Inspector General for Tax Administration's (TIGTA) statement concerning offset fees being substantially less than required to ensure reimbursement of total program costs, resulting in a projected program shortfall, was incorrect. The FMS stated that the program is not a fully reimbursable program, and receives some direct appropriated money to support the program. The FMS expressed concern that the statement implied that FMS management made an arbitrary adjustment that caused a shortfall.

The TIGTA continues to believe that the Code of Federal Regulations requires agencies to reimburse FMS for the full cost of the offset program, which would negate the need for direct appropriations to support the program. The TIGTA is encouraged that the FMS is working towards full reimbursement, and again suggests that decisions to not cover total costs be documented to fully support how fees are established.

FMS and IRS management's comments have been incorporated into the report where appropriate, and their complete responses are included as Appendices V and VI, respectively.

Objective and Scope

The overall objective of this review was to determine the accuracy of offset fees associated with the TRO and the TL services.

The overall objective of this review was to determine the accuracy of offset fees associated with two segments of the Treasury Offset Program (TOP): the Tax Refund Offset (TRO) service and the Tax Levy (TL) service.

The audit was performed at the request of the Internal Revenue Service (IRS) for assistance in reviewing the methodology used by both the IRS and the Financial Management Service (FMS) to establish the fees for the TRO and TL services. Our audit work did not involve specific transaction testing of incurred program costs. However, we did review cost and volume roll-up documents to assess the reasonableness and accuracy of numbers used in the establishment of per-offset fees for the debt collection services included in this audit. We coordinated our audit work with the Department of the Treasury's Office of Inspector General, who has audit responsibility for the FMS. The audit work was conducted from December 2000 through May 2001 within the IRS' Wage and Investment, and Small Business/Self-Employed Divisions, and the FMS' Debt Management Services (DMS) office in Washington, DC. The audit was performed in accordance with *Government Auditing Standards.*

Details of our objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

Since 1986, the IRS has collected delinquent debt owed to federal agencies by offsetting tax refunds. The Debt Collection Improvement Act of 1996[1] provided that any

[1] Pub. L. No. 104-134, 110 Stat. 1321-358.

non-tax debt or claim owed to the United States Government would be referred to the Department of the Treasury. In January 1999, the IRS program was merged with the centralized administration offset program operated by the FMS, known as the TOP.

The TOP is a mandatory, governmentwide debt collection program that compares delinquent debtor data to federal payment data. The TOP recovers delinquent debt by offsetting federal payments scheduled to be issued to debtors.

The FMS is a bureau of the Department of the Treasury, and part of its mission is to provide centralized debt collection services to most federal agencies. The DMS of the FMS is responsible for the TOP. The TOP is a mandatory, governmentwide debt collection program that compares delinquent debtor data to federal payment data. The TOP recovers delinquent debt by offsetting federal payments scheduled to be issued to debtors.

The IRS and the FMS work together to administer two of the TOP debt collection services. The first of these is the TRO service. The TRO involves the FMS offset of federal tax refunds for the collection of non-tax debts. These debts include past-due child support,[2] federal agency debt,[3] and past-due state income tax obligations.[4]

The TRO is user funded. Both the IRS and FMS costs are recovered through per-offset fees deducted from proceeds prior to disbursement to state or federal creditor agencies. These fees, which are established annually by the FMS, are authorized by the codification of the Debt Collection Improvement Act of 1996.[5] The IRS' share of total per-offset fees is documented in an annual IRS/FMS Interagency Agreement. For Calendar Year (CY) 2001, the IRS projected that it will have over 2.7 million offsets at a cost of over $13 million.

The second service in TOP debt collection is the TL service. This involves a continuous IRS levy on FMS

[2] 26 U.S.C. § 6402(c) and the Social Security Act (42 U.S.C. § 664) as of January 5, 1999.

[3] 26 U.S.C. 6402(d) and 31 U.S.C. § 3720A as of January 5, 1999.

[4] 26 U.S.C. § 6402(e) as of January 5, 1999.

[5] 31 CFR §§ 285.2(i), 285.3(h), and 285.8 as of September 7, 2000.

disbursements to individuals and businesses with delinquent tax liabilities, as authorized by the Taxpayer Relief Act of 1997.[6]

The IRS, in accordance with the Economy Act,[7] reimburses the FMS for its costs to administer the TL service. The FMS annually projects its costs for the service and estimates a per-offset fee to cover those costs. The IRS commits to reimburse the FMS for the costs of actual levy actions through the execution of an annual IRS/FMS Interagency Agreement.

The FMS and the IRS are to keep offset fees at the lowest possible level, consistent with the requirements of the law and regulations and the agencies' costs for administering these programs.

Results

Legal authorization for the IRS' participation in the TOP has been established through legislation and Interagency Agreements. Roles and responsibilities for the TRO and TL services have been defined for the IRS and the FMS. These roles and responsibilities are the basis for determining costs associated with the services and were used to establish reimbursable fees authorized by legislation.

The IRS and FMS have processes in place to identify total costs associated with the TRO and TL services. A reasonable fee was established for the IRS' share of the TRO services; however, fees established for the FMS' share of the TRO services did not directly reflect estimated FMS costs or allow for full recovery of costs incurred for the services. Further, the fee established for the TL service was not sufficiently supported, nor was

[6] 26 U.S.C. § 6331(h) as of January 5, 1999.

[7] 31 U.S.C. § 1535 as of January 5, 1999.

the IRS/FMS Interagency Agreement updated to reflect current tax levy conditions.

The Internal Revenue Service Fee Structure for the Tax Refund Offset Services Substantially Covered Its Estimated Program Costs

The IRS' CY 2001 TRO offset fee is reasonable in covering its estimated costs.

For CY 2001, the IRS established its TRO per-offset fee at $4.70. The IRS derived this fee by estimating its total costs ($13,067,730) for participation in the TRO service and then dividing that amount by the number of estimated offsets (2,781,771). In our opinion, based on available supporting documentation, the IRS' CY 2001 TRO offset fee is reasonable in covering its estimated costs.

Though the IRS did not use a formal cost accounting system to record costs associated with the TRO, it has developed a set of various assumptions based on historical data to estimate total TRO participation costs. For example, the IRS took all of the refund offsets from 1998 through 2000 and compared them to the number of injured spouse claims[8] resulting from a refund offset for the same period. By doing this, the IRS was able to establish an assumption that about 11.75 percent of all refund offsets will generate an injured spouse claim. The IRS also determined that about half of all injured spouse claims received by the IRS resulted in the IRS issuing a manual refund. These assumptions are critical since the IRS estimates 90 percent of the cost for participation in the TRO involves work directly associated with processing injured spouse claims. This work is not automated and the processing is mostly manual, making it a costly component of processing the

[8] Injured Spouse Claim and Allocation (Form 8379); this form is used to compute the portion of a joint tax refund due the injured spouse when either all or part of the refund initially was applied against a past-due child support obligation or a federal debt owed by the other spouse.

claims. Further, the number of injured spouse claims has increased as the number of offsets has increased.

The above assumptions were accurately applied to detailed schedules of IRS direct, indirect, and administrative cost data in estimating the costs for participating in the TRO service. Cost data included such items as salaries, benefits, equipment, utilities, and supplies. The cost estimates were then used to establish the IRS' TRO offset fee.

The IRS is continually working to update and fine tune its assumptions to achieve the highest level of accuracy. The IRS also works with the FMS to arrive at the best possible figures for the number of expected offsets to be used in calculating the IRS' TRO offset fee.

While the Financial Management Service's Total Offset Program Budget Was Reasonable, Tax Refund Offset Fees Did Not Directly Reflect Estimated Costs or Allow for Full Recovery of Costs Incurred

For Fiscal Year (FY) 2001, the FMS estimated the total costs of the TOP, of which the TRO is a service, to be $32,405,767 and the total anticipated offsets to be 2,823,606. The total costs were based on FY 2001 budget funding as of March 2000, allocation of program area employee costs, and related indirect costs. We were able to trace the total estimated cost figures and anticipated TRO offsets to supporting documentation and, in our opinion, these figures are reasonable.

The FMS established FY 2001 TOP individual service offset fees, based on the type of offset, which resulted in a projected $13,877,087 program shortfall.

However, the FMS established TOP individual service offset fees, based on the type of offset, that were not directly reflective of estimated FMS TOP costs. These offset fees, though higher than in previous years, were still substantially less than required to ensure reimbursement of total FY 2001 program costs and resulted in a projected program shortfall of $13,877,087.

The following table illustrates the FMS' FY 2001 established offset fees and the estimated program shortfall. Appendix IV also provides a description of the potential benefits to the FMS concerning the reliability of information.

Estimated FMS TOP Fees and Related Reimbursement for Fiscal Year 2001

Offset Type/Service	Volume	Fee	Revenue
Tax Refund Offsets (TRO) – General	1,195,400	$7.05	$8,427,570
TRO - Child Support	1,454,600	$5.50	$8,000,300
TRO - State Tax	60,000	$11.75	$705,000
Total TRO	2,710,000		$17,132,870
Tax Levy	71,694	$12.60	$903,344
Other TOP Services	41,912	$11.75	$492,466
Total	2,823,606		$18,528,680
TOP Budget			$32,405,767
Program Cost Shortfall			($13,877,087)

Source: FMS cost allocation document.

Based on these figures, we calculated the FY 2001 average per-offset fee for all TOP offsets including the TRO to be $11.48,[9] assuming full cost recovery through creditor agency reimbursements and without consideration of the offset fee difference for the TL service as described on page 9 of this report.

The FMS explained that it receives special appropriated funds and makes use of other direct FMS appropriations to cover any shortfalls that result from the establishment of offset fees charged to creditor agencies that do not cover incurred costs. The FMS further commented that when it took over the TRO from the IRS it continued the

[9] $32,405,767 TOP budget divided by 2,823,606 estimated offset volume.

differential[10] in the offset fees already established since it would have caused a dramatic increase in the offset fees charged to the individual creditor agencies. The FMS plans to steadily increase per-offset fees until it does recover total cost. However, until that happens, it will rely on direct appropriations to cover any associated shortfalls.

Based on these FMS practices, we are unable to comment on the reasonableness of the individual TRO offset fees established by the FMS for FY 2001, other than to state that the offset fees established, combined with the FMS appropriations, covered the estimated cost of the TRO service.

Further, even though FMS management decisions provided for the use of special and direct appropriations to cover program shortfalls, we believe that the TRO portion of TOP offset fees should have been established in accordance with the Code of Federal Regulations. Section 285 of Title 31 *Debt Collection Authorities Under The Debt Collection Improvement Act of 1996*, provides for the collection of offset fees by the FMS from individual creditor agencies that reimburse the FMS for the full cost of administering the TRO services. If offset fees were established that reflected total TRO services costs, additional direct appropriations to the FMS would not be needed. Also, the use of total cost reimbursement offset fees would more accurately reflect the true cost of the services provided to the creditor agencies.

Recommendation

1. The FMS' DMS should ensure that TRO offset fees reflect the total costs of the corresponding debt collection services, thereby eliminating the need for

[10] The word differential as used in this sentence refers to the fee difference among the TRO services, i.e., General services fees are higher than Child Support fees.

additional appropriated funds to cover program shortfalls. Decisions to not cover total costs should be documented to fully support how the individual fees are established.

FMS Management's Response: The FMS concurred with the recommendation. The FMS captures costs associated with the debt program in an activity-based cost model. In order to move the debt collection program towards full reimbursement, fees are increased each year, and shortfalls are covered by direct appropriation. Fee increases are held as low as possible to avoid unduly burdening agencies.

Office of Audit Comment: In its response, the FMS commented that the Treasury Inspector General for Tax Administration's (TIGTA) statement concerning offset fees being substantially less than required to ensure reimbursement of total program costs, which resulted in a projected program shortfall, was incorrect. The FMS stated that the program is not a fully reimbursable program, and receives some direct appropriated money to support the program. The FMS expressed concern that the statement implied that FMS management made an arbitrary adjustment that caused a shortfall.

The TIGTA continues to believe that the Code of Federal Regulations requires agencies to reimburse FMS for the full cost of the offset program, which would negate the need for direct appropriations to support the program. The TIGTA is encouraged that the FMS is working towards full reimbursement, and again suggests that decisions to not cover total costs be documented to fully support how fees are established.

The Tax Levy Service Fee Was Not Sufficiently Supported, Nor Was the Interagency Agreement Updated to Reflect Current Levy Conditions

The FY 2001 TL service offset fee estimate was not supported by detailed cost documentation.

Both the FMS and the IRS were aware that the TL service is more costly than other offset services. This is due to an IRS request that the FMS prepare daily collection files and daily refund transfers that are not performed for the other debt collection services. As a result, the FMS established a FY 2001 per-offset fee of $12.60 for the TL service, which represented an increase over the average offset fees charged for other debt collection services. However, the FMS did not accumulate administrative costs by individual debt collection service, including the extra cost of the IRS' request for additional actions associated with TL services. Therefore, no detailed cost documentation was available to support the establishment of the TL offset fee.

The Economy Act[11] provides for payment of goods or services provided by one agency to another agency based on the actual costs of the goods or services provided.

Notwithstanding the discussion on the FMS' establishment of TRO offset fees, which affects all TOP offset fees including TL offset fees, and without identifying the additional costs associated with daily recordkeeping for the TL service, the FMS cannot be certain that the $12.60 fee charged to the IRS is appropriate or sufficient.

The Interagency Agreement for the TL service was based on a higher number of levies than were actually occurring, creating an overcommitment of IRS appropriated funds.

The FY 2001 IRS/FMS Interagency Agreement for the TL service was signed on January 31, 2001, and provided for reimbursement from the IRS to the FMS of $1,599,998 for 126,984 levies (at $12.60 each), if all such levy actions actually occurred. The budget amount was obtained from an IRS project approval document

[11] U.S.C. Title 31 § 1535 as of January 5, 1999.

that describes the project life and multi-year estimated costs for the TL service.

As of May 23, 2001, the FMS reported the recording of 24,061 levy actions, with 14,323 of the actions occurring from late February through May 2001. The decrease in offsets from the original estimate was due to delays in implementing additional payment sources and the IRS not activating anticipated levy debts under the TL service. Though the decreases in levy actions were known by both the IRS and the FMS, no actions were taken to amend the original Interagency Agreement.

Using the actual figure of 24,061 levies recorded, and giving consideration to the increase from February through May, we estimate the completion of approximately 43,200 levies through the end of FY 2001 at an estimated cost of $544,320 (43,200 x $12.60), if levy patterns continue as experienced through May 23, 2001. Although the reimbursement to the FMS will ultimately be based on the actual number of levy actions, the current IRS commitment of $1,599,998 as shown on the Interagency Agreement represents a possible $1.1 million overcommitment of IRS appropriated funds that are unavailable for other IRS expenditures. While our calculations are not statistically valid projections, they are being presented to illustrate the potential magnitude of this issue. Appendix IV provides further details for the potential $1.1 million in funds to be put to better use.

The TL service is a relatively new activity that began in July of 2000. After the TL service has stabilized and more tax levy debts have been activated, both the IRS and the FMS should be able to gain experience with estimating the number of levies and associated costs with more precision.

The FMS has recognized the importance of recording accurate costs to individual services and, as a result, has teamed with an outside contractor to implement a cost-capturing model for its debt management processes. The objectives of the effort are to determine the costs of

FMS services and the costs associated with FMS activities to provide a dynamic cost-capturing model that enables periodic updating. A draft report of the contractor's efforts was issued on March 6, 2001. One of the activities identified was to "Provide Tax Levy Accounting Operations." The specific identification of this activity should allow the FMS to segregate specific TL service costs and more accurately calculate the TL offset fee charged to the IRS.

The contractor also suggested updating the model on a quarterly or semi-annual basis to reflect the most current cost information.

Recommendations

2. The FMS' DMS should capture the actual costs for the TL service and adjust other service offset fees accordingly, including periodically updating cost information to reflect the most current offset conditions.

FMS Management's Response: The FMS concurred with the recommendation. The FMS will document the process used to isolate and track the additional costs associated with the TL service.

3. The IRS' Wage and Investment, and Small Business/Self-Employed Divisions, and the FMS' DMS should coordinate to timely amend Interagency Agreements, including the FY 2001 Agreement noted in this report, when current information shows that offset fee estimates are significantly misstated.

IRS Management's Response: On August 9, 2001, the IRS requested a change in the FY 2001 Interagency Agreement and based its FY 2002 Interagency Agreement estimate on historical information that is now available. This data enabled the IRS to be more accurate in its estimates and it should limit the potential for overcommitment of funds.

FMS Management's Response: The FMS concurred with the recommendation. As the levy program continues, the IRS and the FMS should be able to gain experience with estimating the number of levies and associated costs with more precision.

Conclusion

The IRS and the FMS have processes in place to identify total costs associated with the TRO and the TL services. A reasonable fee was established for the IRS' share of the TRO services; however, fees established for the FMS' share of the TRO services did not directly reflect estimated FMS costs or allow for full recovery of costs incurred for the services. Further, the fee established for the TL services was not sufficiently supported, nor was the FY 2001 IRS/FMS Interagency Agreement updated to reflect current volumes of tax levy offsets.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine the accuracy of offset fees associated with two segments of the Treasury Offset Program (TOP): the Tax Refund Offset (TRO) service and the Tax Levy (TL) service. To accomplish our objective, we:

I. Gained an understanding of the process and related controls to establish, maintain, and participate in the TRO and TL services.

   A. Obtained legislation and interagency agreements authorizing the TRO and TL services.

   B. Interviewed Internal Revenue Service (IRS) management and personnel to document their roles and responsibilities for the TRO and the TL.

   C. Interviewed Financial Management Service (FMS) management and personnel to document their roles and responsibilities for the TRO and TL services. Coordinated these interviews with the Treasury Office of Inspector General.

   D. Compared the results of step A with those of steps B and C to identify any inconsistencies.

II. Determined whether all costs associated with the TRO and TL services are accurately and timely recorded and reported in determining offset fees. Subject costs include direct costs (salaries, benefits, space, travel, etc.) as well as indirect costs (shared information technology, field support, legal, etc., in addition to FMS-provided support).

   A. Identified all costs associated with performing all roles and responsibilities for the TRO services.

   B. Identified all costs associated with performing all roles and responsibilities for the TL service.

   C. Identified all costs that are included in the formulas for the currently established annual offset fees and recalculated fees based on those costs.

   D. Compared the results of steps A and B with those of step C to determine whether only those costs associated with program roles and responsibilities are included in the formula for establishing offset fees.

III. Determined whether TRO and TL services costs and benefits are monitored and validated by the IRS and the FMS to provide complete and accurate information to evaluate participation in the programs.

A. Reviewed policies and guidelines for capturing data and reporting results of program costs and benefits.

B. Interviewed IRS and FMS personnel involved in the TRO and TL services to determine what processes are used to monitor and validate program costs and benefits.

Appendix II

Major Contributors to This Report

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Appendix III

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Appendix IV

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Reliability of Information – Potential; management of a $32.4 million program that affects 2.8 million debt collection offset actions, with a projected reimbursement shortfall to the Financial Management Service (FMS) of approximately $13.9 million (see page 5).

Methodology Used to Measure the Reported Benefit:
For Fiscal Year (FY) 2001, the estimated cost of the Treasury Offset Program (TOP) was $32,405,767. The established fees for the estimated 2,823,606 offsets would generate estimated revenue of $18,528,680, creating a projected $13,877,087 shortfall in reimbursement to the FMS for TOP costs. The total cost figure, estimated offsets, and projected shortfall were obtained from a FMS cost allocation document.

Type and Value of Outcome Measure:

- Funds to Be Put to Better Use – Potential; approximately $1.1 million in Internal Revenue Service (IRS) committed funds (see page 9).

Methodology Used to Measure the Reported Benefit:
As of May 23, 2001, the FMS reported the recording of 24,061 levy actions, with 14,323 of the actions occurring from late February through May 2001.

Using the actual figure of 24,061 levies recorded, and giving consideration to the increase from February through May, we estimate the completion of approximately 43,200 levies through the end of FY 2001, if levy patterns continue as experienced through May 23, 2001. Accordingly, the IRS could expect to reimburse FMS $544,320 (43,200 * $12.60). Comparing this amount to the $1,599,998 shown on the FY 2001 IRS/FMS Interagency Agreement results in a potential overcommitment of IRS appropriated funds of approximately $1.1 million. Our calculations are not statistically valid projections but are presented to illustrate the potential magnitude of this issue.

Our estimate of 43,200 (rounded) expected levies was calculated as follows:

Levies recorded from February 22, 2001, to May 23, 2001	14,323
Divided by 3 elapsed months	3
Levies per month	4,774
Times 4 months remaining in FY 2001	4
Levies for the remaining 4 months of FY 2001	19,096
Plus levies recorded through May 23, 2001	24,061
Projected FY 2001 levies	43,157

Appendix V

Financial Management Service Management's Response to the Draft Report

COMMISSIONER

DEPARTMENT OF THE TREASURY
FINANCIAL MANAGEMENT SERVICE
WASHINGTON, D.C. 20227

RECEIVED
OCT 1 1 2001

October 11, 2001

MEMORANDUM FOR MAURICE MOODY
ASSISTANT INSPECTOR GENERAL FOR AUDIT
(HEADQUARTERS OPERATIONS AND EXEMPT ORGANIZATION PROGRAMS)

FROM: RICHARD L. GREGG Richard L Gregg

SUBJECT: Response to Draft Audit Report (Improvements are Needed in Establishing Yearly Offset Fees for the Treasury Offset Program)

Thank you for the opportunity to respond to the findings and recommendations in the audit report, "Improvements Are Needed in Establishing Yearly Offset Fees for the Treasury Offset Program." The comments provided below address the report recommendations, as well as other related discrepancies that require clarification.

Recommendation

1. The Financial Management Services' (FMS') Debt Management Service (DMS) should ensure that TRO offset fees reflect the total costs of the corresponding debt collection services, thereby eliminating the need for additional appropriated funds to cover program shortfalls. Decisions to not cover total costs should be documented to fully support how the individual fees are established.

FMS Response

FMS concurs with recommendation #1.

In support of this recommendation, TIGTA notes on page 5, "These offset fees, though higher than in previous years, were still substantially less than required to ensure reimbursement of total FY 2001 program costs, (as we believe is required by the Code of Federal Regulations), and resulted in a projected program shortfall of $13,877,087."

This statement is incorrect. First, FMS' program is not a fully reimbursable program. FMS currently receives some direct appropriated money to support this program, although the appropriation declines annually. This statement implies that FMS

Page 2- Response to Draft Audit Report (Improvements are Needed in Establishing Yearly Offset Fees for the Treasury Offset Program)

management made an arbitrary adjustment that caused a $13,877,087 shortfall. That is not the case. FMS' direct appropriation covered that amount.

When FMS took over TRO from IRS in January 1999, it continued the differential in fee charges already established: Federal agencies were charged $1.55 more than Child Support agencies. Since FMS was taking on a large portion of IRS' workload, there was an expectation that IRS' fee would drop. In reality, IRS did not drop its fees; rather, it wanted an increase. This put FMS in a very difficult situation. To partially cover its costs, FMS was forced to charge a fee that was substantially less than its actual (total) costs. To completely cover FMS costs would have required us to dramatically increase fees charged to agencies which could have resulted in many agencies declining to refer debts at a time when the debt collection program was still in its growing stages. Since then, FMS has attempted to have IRS look at its costs from a cost accounting standpoint and to actually track the costs associated with the offset program.

In the meantime, FMS has based its fees on the following:

A. FMS captures costs associated with the debt program in an activity-based cost model;

B. Total costs for debt work at FMS are compared to total projected offsets. These numbers are divided and this becomes the fee charged for a regular administrative offset; and,

C. In order to move the debt collection program towards full reimbursement, administrative offset and tax refund offset fees are increased each year to move them closer to the fee determined in Step B. FMS holds fee increases as low as possible to avoid unduly burdening agencies or child support offices. Shortfalls are covered by direct appropriation.

Recommendation

2. The FMS' DMS should capture the actual costs for the Tax Levy service and adjust other service offset fees accordingly, including periodically updating cost information to reflect the most current offset conditions.

FMS Response

FMS concurs with recommendation #2.

Page 3- Response to Draft Audit Report (Improvements are Needed in Establishing Yearly Offset Fees for the Treasury Offset Program)

TIGTA notes on page 8, "Both the FMS and the IRS were aware that the Tax Levy service is more costly than other offset services. As a result, the FMS established a per-offset fee of $12.60 for the Tax Levy service for FY 2001."

The IRS requested that we develop a custom system for Tax Levy, featuring such capabilities as daily file and money transfers. FMS included these additional costs in determining the total program costs and then divided the total costs by the projected number of levies in order to obtain the per levy fee. In the future FMS will document the process used to isolate and track these costs.

Recommendation

3. The IRS' Wage and Investment, and Small Business/Self-Employed Divisions, and the FMS' DMS should coordinate to timely amend Interagency Agreements, including the FY 2001 Agreement noted in this report, when current information shows that offset fees estimates are significantly misstated.

FMS Response

FMS concurs with recommendation #3.

On page 9, TIGTA discusses the interagency agreement that provided for a higher dollar amount than the projected number of levies. Although, at the request of the IRS staff, the agreement contained this higher dollar amount, the agreement specifically stated that the actual reimbursement to FMS would be based on the actual levies. In September 2001, IRS amended the interagency agreement with FMS to reduce the commitment by $1.1 million. We agree that IRS and the FMS should be able to gain experience with estimating the number of levies and associated costs with more precision as the levy program continues.

General Comments

On page 2, TIGTA notes, "These fees, which are established annually by the FMS, are authorized by the codification of the Debt Collection Improvement Act of 1996."

This sentence should state "These fees, which are established annually by the FMS, are authorized by Federal Law." [1]

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[1] See footnotes 2 - 4;31CFR §§ 285.2(i),285.3(h), and 285.8 as of September 7, 2000.

Page 4- Response to Draft Audit Report (Improvements are Needed in Establishing Yearly Offset Fees for the Treasury Offset Program)

On page 4, TIGTA states, "For Calendar Year 2001, the IRS established its per-offset fee at $4.70. The IRS derived this fee by estimating its total costs incurred ($13,067,730) for participation in the TRO service and then dividing that amount by the number of estimated offsets (2,781,771)."

According to this statement, IRS divided one number by another number and came up with their fee amount. It is not clear, however, how IRS derived the $13,067,730 cost figure in the first place and nothing in the report indicates that TIGTA verified that IRS is actually spending this much money to support the program.

Since FMS took over the program, IRS total costs have stayed about the same or increased, despite FMS assuming responsibility for many functions previously performed by the IRS, including all agency file transfers, the help desk (which had a volume of 2.2 million calls last year), and maintaining the database and running the system.

On page 7, TIGTA states, "... we believe that the TRO portion of TOP offset fees should have been established in accordance with the Code of Federal Regulations. Section 285 of Title 31 *Debt Collection Authorities Under The Debt Collection Improvement Act of 1996*, provides for the collection of offset fees by the FMS from individual creditor agencies that reimburse the FMS for the full cost of administering the TRO services."

FMS is continuing to rollout the TOP program as we add new debts and payment streams to the system. Continuing efforts such as Benefit Offset and Salary Offset will continue to increase offset volumes and revenues over time. As FMS continues to phase in more program functionality, it will also be phasing in increases to its fees to more fully recover the cost of the program. This approach to fee increases will encourage agency participation and not overburden agencies that pay the fees from direct appropriations.

We agree with the finding on page 10 that FMS should continue to employ the activity-based cost model. FMS will continue to capture costs associated with the debt program and make improvements as necessary. However, we believe that the IRS should follow the same cost accounting standards in tracking and matching its activities to costs. The same standard should be applied to both parties.

If you have further questions, please contact Martin Mills, Acting Assistant Commissioner of Debt Management Services, on 874-3810.

Appendix VI

Internal Revenue Service Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
OCT 23 2001

OCT 22 2001

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Joseph G. Kehoe
Commissioner, Small Business/Self-Employed

SUBJECT: Draft Audit Report – Improvements Are Needed in Establishing Yearly Offset Fees for the Treasury Offset Program

I have reviewed your report and am providing my comments regarding the Federal Levy Payment Program (FPLP) portion. I agree the estimate of fees for FY 2001 were misstated.

The FPLP started in July 2000 and we had very little historical data to determine costs. We relied heavily on GAO estimates from their report of the FPLP dated April 7, 2000 and their Payment Data Matching briefing dated March 28, 2001 for our projections. On August 9, 2001, when SB/SE management was certain the estimates were overstated, a request to change the Interagency Agreement was initiated and the excess money was "deobligated." We currently have more than 16 months of historical data upon which to base our FY 2002 projections. SB/SE management is confident the FY 2002 Interagency Agreement will be much more accurate.

It is our understanding FMS is responding to recommendations one and two, which pertain to their processes. Our comments on recommendation three follow:

IDENTITY OF RECOMMENDATION 3
The IRS' Wage and Investment, and Small Business/Self-Employed Divisions, and the FMS' DMS should coordinate to timely amend Interagency Agreements, including the FY 2001 Agreement noted in this report, when current information shows that the offset fee estimates are significantly misstated.

ASSESSMENT OF CAUSE
The Treasury Inspector General for Tax Administration (TIGTA) estimated that the FY 2001 Interagency Agreement between IRS and FMS may have been overcommited by as much as $1.1 million.

2

CORRECTIVE ACTION
On August 9, 2001, we requested a change in the FY 2001 Interagency Agreement. We have based our FY 2002 estimate on historical information that is now available. This data enabled us to be more accurate in our estimate and are confident it will limit the potential for overcommitment of funds.

IMPLEMENTATION DATE
Completed

RESPONSIBLE OFFICIALS
Director, Filing and Payment Compliance, Small Business/Self-Employed

CORRECTIVE ACTION MONITORING PLAN
N/A

If you have any questions, please call Martha Sullivan, Deputy Director Compliance Policy, Small Business/Self-Employed, at 202-283-2144.